

FDI, Government Expenditure, Inflation and Local Tax Ratio in Indonesia: Does Corruption Matter?

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ABSTRACT

This study analyzes the effects of Foreign Direct Investment (FDI), government expenditure, and inflation on the local tax ratio in Indonesia, while examining whether corruption conditions these relationships. The local tax ratio is employed as a partial indicator of local tax effort, reflecting the effectiveness of subnational governments in mobilizing locally assigned tax revenues within the institutional constraints of fiscal decentralization. Using balanced panel data from 33 Indonesian provinces over the period 2015–2024, the study applies a moderated regression analysis (MRA) to estimate both direct and interaction effects. The results indicate that government expenditure has a positive and statistically significant effect on the local tax ratio, whereas inflation exerts a significant negative effect. The effect of FDI is positive in baseline estimations but loses statistical significance after accounting for institutional interactions. Further analysis shows that corruption significantly moderates the relationship between government expenditure and the local tax ratio by weakening its positive fiscal impact, while its moderating effects on the relationships involving FDI and inflation are not statistically significant. These findings suggest that improvements in governance quality and public financial management are essential to enhance the effectiveness of public spending in strengthening local tax ratio, while also highlighting the structural limitations faced by local governments in translating investment and macroeconomic conditions into higher tax revenues.

Keywords: Foreign Direct Investment, Government Expenditure, Inflation, Local Tax Ratio, Corruption

INTRODUCTION

Regional autonomy in Indonesia demands that local governments strengthen their own-source revenue to reduce reliance on central transfers (Miswar et al., 2021). However, the capacity of Indonesian provinces to generate local revenue, particularly from local taxes, remains weak. Data from the Ministry of Finance shows that 42.11% of provinces still have low fiscal capacity, reflecting continued dependence on central government funding. The local tax ratio, as an indicator of regional fiscal capacity, remains low at around 0.7–1.5% between 2015 and 2023, far below the national tax ratio of 10.31% in 2023, signalling the urgency to enhance provincial tax mobilization.

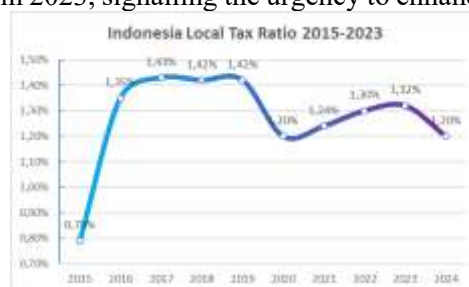


Figure 1. Local Tax Ratio in Indonesia
Source: Ministry of Finance

Foreign direct investment (FDI) is expected to stimulate regional economic activity and broaden the tax base (Fazaalloh, 2024). Although Indonesia's FDI inflows surged from IDR 403 trillion in 2015 to IDR 940 trillion in 2024, provincial tax revenues did not grow proportionately. This suggests a weak transmission of FDI benefits into fiscal outcomes at the local level. Similarly, government expenditure should theoretically support tax growth through infrastructure, public services, and economic development (Nguyen & Bui, 2022). Yet, many high-spending provinces still report low local tax ratios, indicating inefficiencies and weak fiscal governance. Inflation further affects fiscal performance by eroding purchasing power and reducing business productivity, potentially narrowing the tax base (Puspasari & Gazali, 2022). Its net impact on the local tax ratio remains uncertain due to the dual effect of rising prices and declining real tax capacity.

Institutional quality may influence how FDI, government spending, and inflation affect local tax ratio. Corruption remains a persistent challenge, Indonesia's CPI score of 37 in 2024 reflects governance weaknesses that undermine tax compliance, distort budget allocation, and weaken investor trust. Corruption can limit the fiscal benefits of FDI, reduce the effectiveness of public expenditure, and directly decrease tax revenue through illicit practices (Wiguna & Wijaya, 2024). While prior studies have analyzed tax determinants and the impact of corruption on fiscal outcomes, limited research has examined corruption as a moderating factor at the provincial level, partly due to limited regional-level corruption data.

To address this gap, this study investigates the influence of FDI, government expenditure, and inflation on the local tax ratio in Indonesian provinces, with corruption as a moderating variable. Strengthening provincial fiscal capacity requires not only attracting quality investment and improving spending effectiveness but also ensuring good governance and inflation stability. This research provides a more comprehensive provincial-level analysis to better understand these dynamics and support strategies for reducing regional fiscal dependence on the central government.

LITERATURE REVIEW

Theoretical Literature Review

Spillover theory explains the indirect transmission of knowledge, technology, and managerial practices from multinational enterprises to domestic firms, which can stimulate local economic activity through productivity gains and employment creation (Surbakti & Wijaya, 2023). While most tax revenues directly generated by foreign direct investment—such as corporate income tax and value-added tax—are collected by the central government in Indonesia, FDI may still influence local tax performance through indirect channels. Increased business activity by foreign firms can raise demand for locally provided services, accommodation, transportation, and commercial space, thereby expanding the base of locally assigned taxes such as hotel and restaurant taxes, advertisement taxes, and property-related taxes (PBB-P2). Moreover, supply-chain linkages and labor absorption associated with FDI can stimulate the growth of domestic firms and household consumption, which further contributes to local tax bases within the scope of subnational taxation.

However, the fiscal implications of these spillovers for the local tax ratio are inherently conditional and constrained by institutional capacity and the design of fiscal decentralization. In regions with limited administrative capacity or weak governance, the potential indirect benefits of FDI may not be fully translated into higher local tax revenues. Therefore, rather than generating direct fiscal effects, FDI spillovers are expected to affect the local tax ratio only indirectly and unevenly, depending on the extent to which local governments can capture increased economic activity through their legally assigned tax instruments.

The spend-tax hypothesis posits that rising government spending leads to higher tax revenues as public tolerance toward taxation increases when spending is perceived as necessary and beneficial (Adigbole et al., 2023). Increased fiscal expenditure, particularly during economic shocks, may initially be financed through borrowing or stable tax rates; however, in the medium to long term, tax revenue must adjust upward to sustain spending. Thus, efficient and productive government spending can stimulate economic activity and expand the tax base, while inefficient spending may fail to yield corresponding increases in local tax ratio.

Local tax ratio measures the contribution of locally assigned tax revenues to Gross Regional Domestic Product (GRDP), reflecting the effectiveness of subnational governments in collecting

taxes within the scope of their legally mandated fiscal authority (Ikidi & Okoh, 2024). Rather than capturing overall fiscal capacity, this ratio indicates the extent of local tax effort and administrative effectiveness in translating regional economic activity into own-source revenue. As a partial indicator of local fiscal performance, the local tax ratio provides insight into the performance of regionally administered taxes and the efficiency of local tax policy implementation, while remaining inherently constrained by the institutional design of fiscal decentralization and the continued reliance on intergovernmental transfers (Surbakti & Wijaya, 2023).

Foreign Direct Investment represents cross-border capital inflows accompanied by technology transfer, managerial know-how, and international production networks. FDI supports capital accumulation, productivity growth, and employment, with its benefits varying across sectors and depending on local absorptive capacity (Wahyuni & Wijaya, 2023). In the provincial context, FDI can stimulate formal economic activity, broaden the tax base, and generate spillovers that support local revenue performance, provided that regional institutions effectively regulate and leverage foreign investment.

Government spending constitutes a key fiscal policy tool influencing economic activity and public service provision (Nan, 2021). It includes expenditures on public goods, services, and social programs at multiple levels of government and aims to enhance welfare and stimulate growth. Efficient and well-targeted spending can stimulate local economic activity, increase taxable transactions, and support revenue generation, whereas poorly managed expenditure weakens fiscal outcomes and undermines tax performance (Maryantika & Wijaya, 2022).

Inflation reflects sustained increases in the general price level and affects purchasing power, production costs, and tax revenues (Andini & Wijaya, 2024). Moderate inflation may increase nominal tax receipts by raising transaction values, yet high and persistent inflation reduces real income, suppresses economic activity, and narrows the tax base (Puspasari & Gazali, 2022). Its impact on local tax ratio depends on regional tax structures and fiscal policy responses, provinces with adaptive tax systems benefit more, while those relying on rigid or fixed-rate levies face erosion of real revenue (Subiyanto et al., 2022).

Corruption diverts public resources for private gain, weakens institutions, and diminishes public trust, thereby undermining fiscal capacity. High discretion, monopoly of power, and weak accountability increase corruption risk (Gaspareniene et al., 2022). At the local level, corruption reduces tax morale, distorts public spending, and weakens revenue administration. It can impede the positive effects of FDI, government spending, and inflation management on local tax ratio, making it a relevant moderating factor in assessing provincial fiscal performance (Eng & Lim, 2024).

Empirical Literature Review

Previous empirical studies provide mixed evidence regarding the relationship between foreign direct investment (FDI) and tax revenue. Several studies document a positive association, showing that FDI can expand business activity, enhance productivity, and create employment, thereby broadening the tax base (Eng & Lim, 2024; Gaspareniene et al., 2022; Surbakti & Wijaya, 2023). From a theoretical perspective, spillover theory suggests that FDI contributes to economic performance primarily through indirect channels, such as technology transfer, supply-chain linkages, and improvements in managerial practices, rather than through direct fiscal contributions.

However, other studies report insignificant or weak effects of FDI on tax revenue, particularly in contexts with limited institutional capacity or constrained fiscal authority at the subnational level (Ikidi & Okoh, 2024). In the context of Indonesia's decentralized fiscal system, where local governments rely on a limited set of locally assigned taxes, the fiscal benefits of FDI are expected to be indirect and contingent upon the extent to which increased economic activity can be captured through local tax instruments. Accordingly, this study hypothesizes that FDI is associated with improvements in local tax performance.

H1: Foreign Direct Investment (FDI) has a positive effect on the Local Tax Ratio

Previous empirical studies consistently document a positive relationship between government expenditure and tax revenue, supporting the spend-tax hypothesis, which posits that higher public spending stimulates economic activity and subsequently expands the tax base (Nan, 2021). Related evidence shows that government expenditure can affect tax revenue both directly,

through increased demand for taxable goods and services, and indirectly, by fostering economic growth and income generation (Maryantika & Wijaya, 2022). Cross-country evidence further suggests that the fiscal impact of government spending depends on its composition, with expenditures on infrastructure and education being more effective in enhancing tax ratios than other spending categories (Adigbole et al., 2023).

From a theoretical perspective, productive public spending improves the provision of infrastructure and public services, reduces transaction costs, and encourages formal economic activity, thereby strengthening the effectiveness of tax collection. In the context of Indonesia's decentralized fiscal system, government expenditure at the provincial level is expected to play an important role in stimulating local economic activity and expanding the base of locally assigned taxes. Accordingly, this study hypothesizes that higher government expenditure is associated with improved local tax performance.

H2: Government Expenditure has a positive effect on the Local Tax Ratio

A substantial body of empirical literature shows that inflation adversely affects tax revenue performance, particularly in developing economies. Rising inflation reduces real purchasing power and suppresses household consumption, which in turn lowers revenues from consumption-based taxes and business-related tax bases (Andini & Wijaya, 2024; Silfiani, 2022). From a theoretical perspective, the Olivera–Tanzi effect explains how inflation erodes the real value of tax revenue through collection lags, weakening fiscal performance even when nominal tax bases expand (Serin & Demir, 2025). Inflation also distorts price signals and economic decision-making, reducing productivity and shrinking taxable economic activity over time (Shrivastava, 2021).

In the context of Indonesia's subnational fiscal system, where local tax revenues largely depend on consumption, services, and property-related taxes, inflationary pressures are expected to disproportionately weaken the local tax base relative to regional output. Consequently, higher inflation is likely to reduce the effectiveness of local tax collection and deteriorate the local tax ratio.

H3: Inflation has a negative effect on the Local Tax Ratio

Although Foreign Direct Investment (FDI) is generally associated with higher tax revenue through economic expansion, productivity improvement, and business formalization, the magnitude of this effect is highly contingent upon institutional quality. Prior studies show that FDI can strengthen tax capacity by broadening the tax base and increasing taxable income when governance mechanisms function effectively (Surbakti & Wijaya, 2023).

However, in environments characterized by weak institutions and high levels of corruption, these fiscal benefits may be substantially reduced. Corruption can facilitate tax avoidance, preferential treatment, and collusive arrangements between firms and public officials, thereby weakening tax compliance and eroding potential tax gains from FDI. Empirical evidence from Nigeria indicates that corruption significantly weakens the positive relationship between FDI and tax performance (Ikidi & Okoh, 2024). Similarly, Wiguna and Wijaya (2024) demonstrate that corruption diminishes the contribution of FDI to corporate tax revenue in the United States by enabling informal incentives and regulatory capture.

Given the heterogeneity of institutional quality across Indonesian provinces, corruption is expected to moderate the relationship between FDI and local tax performance. Higher levels of corruption are likely to reduce the effectiveness of FDI in enhancing the local tax ratio by undermining transparency, enforcement, and voluntary tax compliance.

H4: Corruption weakens the positive effect of Foreign Direct Investment on the Local Tax Ratio

Government expenditure is widely recognized as a key instrument for stimulating economic growth, improving public service provision, and expanding tax capacity. Empirical studies generally find that productive public spending—particularly on infrastructure, education, and economic services—can enhance the tax base and increase tax ratios (Nan, 2021). Through improved connectivity, human capital development, and economic efficiency, government spending is expected to strengthen tax collection performance.

However, the effectiveness of public expenditure in generating fiscal returns critically depends on governance quality. In the presence of high corruption, public spending is often distorted through inefficiency, misallocation, and budget leakages, which weaken its contribution

to productive economic activities. Corruption may reduce the growth-enhancing impact of public spending by diverting funds away from priority sectors, inflating project costs, and lowering the quality of public outputs. Nguyen and Bui (2022) highlight that weak governance limits the ability of government expenditure to translate into improved fiscal outcomes, although empirical evidence on the moderating role of corruption remains limited.

Given the variation in institutional quality across Indonesian provinces, corruption is expected to moderate the relationship between government expenditure and local tax performance. Higher levels of corruption may reduce the effectiveness of government spending in expanding the tax base and improving tax compliance, thereby weakening its impact on the local tax ratio.

H5: Corruption weakens the positive effect of Government Expenditure on the Local Tax Ratio

Inflation is widely recognized as a macroeconomic factor that weakens fiscal performance by eroding real income, reducing purchasing power, and suppressing consumption and business profitability. These mechanisms shrink the taxable base and reduce the real value of tax revenue, particularly in developing economies. Empirical evidence confirms that inflation negatively affects tax performance through reduced economic activity and lower tax compliance (Kurniasih et al., 2024; Santos & Menezes, 2024).

The adverse fiscal impact of inflation is further conditioned by institutional quality, especially corruption. In high-corruption environments, weak enforcement, rent-seeking behavior, and administrative inefficiencies undermine the effectiveness of tax administration and intensify revenue losses during inflationary periods. Margaryan and Terzyan (2023) and Peixoto et al. (2022) show that corruption exacerbates inflationary distortions by weakening institutional capacity, fiscal credibility, and economic productivity. Moreover, inflation-induced uncertainty may create greater opportunities for bribery and informal transactions, discouraging formal economic participation and accurate tax reporting.

Given these interactions, corruption is expected to amplify the negative impact of inflation on local fiscal performance. At the provincial level in Indonesia, higher corruption may strengthen the adverse effect of inflation on the local tax ratio by jointly eroding real economic activity, tax compliance, and administrative effectiveness.

H6: Corruption strengthens the negative effect of Inflation on the Local Tax Ratio

METHODS

Research Design

This study employs a quantitative research design using panel data analysis to examine the determinants of the Local Tax Ratio across Indonesian provinces. A hierarchical moderated regression analysis (HMRA) is applied to assess the direct effects of Foreign Direct Investment (FDI), government expenditure, and inflation on the Local Tax Ratio, as well as the moderating role of corruption. The analysis covers the period 2015–2024 and focuses on 33 provinces in Indonesia, excluding newly established provinces to maintain data consistency and comparability over the observation period.

Definition and Operationalization of Variables

The definitions and operational measurements of each variable used in this study are presented in Table 1.

Table 1. Operational Definition of Variables

Variable	Measurement/Indicator	
Dependent		
Local Tax Ratio (LTR)	Local Tax and Retribution Revenue / GRDP	Adigbole et al. (2023)
Independent		
Foreign Direct Investment (FDI)	Realized FDI Inflow/ GRDP	Wiguna & Wijaya (2024)
Government Expenditure (GEX)	Annual government expenditure / GRDP	Adigbole et al. (2023)
Inflation (INF)	Annual provincial inflation rate (%)	Silfiani & Febyansyah (2022)
Moderating		
Corruption (CR)	Number of corruption cases per 10,000 population	Pertiwi & Haryanto (2022)

Model Specification



This study adopts a hierarchical moderated regression analysis (HMRA) approach consisting of three sequential models to examine both the direct and moderating effects among variables. The models are specified as follows:

Model 1: Assesses the influence of independent variables on the Local Tax Ratio

$$TR = \beta_0 + \beta_1 FDI + \beta_2 GEX + \beta_3 INF \quad (1)$$

Model 2: Examines the effect of FDI, government expenditure, and inflation on the Local Tax Ratio

$$TR = \beta_0 + \beta_1 FDI + \beta_2 GEX + \beta_3 INF + \beta_4 CR \quad (2)$$

Model 2: Tests whether corruption moderates the relationship between the independent variables and the Local Tax Ratio by adding interaction terms.

$$TR = \beta_0 + \beta_1 FDI + \beta_2 GEX + \beta_3 INF + \beta_4 CR + \beta_5 FDI_CR + \beta_6 GEX_CR + \beta_7 INF_CR \quad (3)$$

RESULTS

To determine the most appropriate panel data estimation technique, a sequence of diagnostic tests was conducted, namely the Chow test, the Hausman test, and the Lagrange Multiplier test. The results, as reported in Table 4, indicate that the Random Effect Model (REM) is the most suitable estimator for regression Models 1 and 2. In contrast, the diagnostic tests for Model 3 suggest that the Fixed Effect Model (FEM) provides the most appropriate specification. Accordingly, the estimation strategy in this study follows the outcomes of the model selection tests to ensure methodological consistency and unbiased inference.

Table 2. Regression Model Selection

Model	Test	Prob.	Conclusion
1	Chow Test	Prob = 0.0000	FEM
	Hausman Test	Prob = 0.0618	REM
	Lagrange Multiplier Test	Prob = 0.0022	REM
2	Chow Test	Prob = 0.0000	FEM
	Hausman Test	Prob = 0.1846	REM
	Lagrange Multiplier test	Prob = 0.0022	REM
3	Chow Test	Prob = 0.0000	FEM
	Hausman Test	Prob = 0.0163	FEM
	Lagrange Multiplier test	Prob = 0.1618	CEM

The F-test results across all three models indicate that the independent variables collectively exert a statistically significant influence on the Local Tax Ratio. Model 1 records an F-statistic of 2.760304 ($p = 0.0000$), while Model 2 shows a similar significant value of 2.651892 ($p = 0.0000$), confirming that the inclusion of FDI, government expenditure, and inflation jointly enhances the model's explanatory power. Model 3, which incorporates interaction terms to assess the moderating role of corruption, exhibits a substantially higher F-statistic of 18.19118 ($p = 0.0000$), indicating a stronger model fit when moderation is considered. In terms of coefficient of determination, the R^2 increases progressively across models, from 0.202562 in Model 1 to 0.246072 in Model 2, and further to 0.283391 in Model 3, demonstrating that the full model with interaction effects explains 28.34% of the variation in the Local Tax Ratio.

Table 3. Result of T-Test and F-Test

Variables	Model 1 (REM)		Model 2 (REM)		Model 3 (FEM)	
	Coeff.	Prob.	Coeff.	Prob.	Coeff.	Prob.
C	0.023210	0.0000***	0.025899	0.0000***	0.022062	0.0000***
FDI	0.012017	0.0000***	0.012337	0.0000***	0.005283	0.3317
GEX	0.039751	0.0000***	0.039318	0.0000***	0.062962	0.0000***
INF	-0.000478	0.0118**	-0.000359	0.0545*	-0.000646	0.0619*
CR			-0.022084	0.0000***	-0.003945	0.7175
FDI_CR					0.027637	0.1556

Variables	Model 1 (REM)		Model 2 (REM)		Model 3 (FEM)	
	Coeff.	Prob.	Coeff.	Prob.	Coeff.	Prob.
GEX_CR					-0.096968	0.0002***
INF_CR					0.002262	0.2878
R2	0.202562		0.246072		0.283391	
Adj. R2	0.195223		0.236793		0.267812	
F-Statistic	2.760304	0.00000***	2.651892	0.00000***	18.19118	0.0000***

Note: *** $p < 1\%$, ** $p < 5\%$, * $p < 10\%$

Table 3 shows that FDI has a positive and significant effect on the local tax ratio in Models 1 and 2, supporting H1, indicating that higher foreign investment contributes to improved local tax ratio. Government expenditure (GEX) also demonstrates a consistently positive and significant effect across all models, supporting H2, meaning increased provincial spending enhances tax revenue. Inflation (INF) has a negative and significant effect, at the 5% level in Model 1 and 10% in Models 2 and 3, supporting H3, confirming that rising inflation weakens local tax ratio. The interaction term between FDI and corruption (FDI_CR) is positive but insignificant, indicating corruption does not moderate the FDI–tax ratio relationship (H4 rejected). Conversely, the interaction between GEX and corruption (GEX_CR) is negative and significant, supporting H5, meaning corruption weakens the positive effect of government spending on the local tax ratio. Meanwhile, the interaction between INF and corruption (INF_CR) is positive but insignificant, suggesting corruption does not moderate the inflation–tax ratio relationship (H6 rejected).

DISCUSSIONS

FDI on Local Tax Ratio

The empirical results show that Foreign Direct Investment (FDI) has a positive and statistically significant effect on the Local Tax Ratio (LTR) in the baseline specification. This finding indicates that higher inflows of foreign capital are associated with stronger local fiscal capacity through indirect economic channels. FDI stimulates regional production, employment, and income generation, which expand the local tax base—particularly through consumption taxes, local business taxes, and fees linked to economic activity rather than direct corporate income taxation (Wahyuni & Wijaya, 2023). In this sense, the result is consistent with spillover-based arguments emphasizing technology transfer, productivity gains, and managerial diffusion from foreign to domestic firms (Ikidi & Okoh, 2024).

However, the positive effect of FDI becomes statistically insignificant once governance-related controls, especially corruption, are introduced. This attenuation suggests that the fiscal benefits of FDI are not structurally robust but conditional on institutional quality. In weak governance environments, the indirect fiscal spillovers of FDI may be constrained by rent-seeking behavior, regulatory capture, and weak tax administration. Foreign firms may rely heavily on tax incentives, engage in profit shifting, or operate with limited backward and forward linkages to the local economy, thereby reducing their contribution to locally collected taxes. Consequently, higher FDI inflows do not automatically translate into proportional improvements in local tax performance.

This result aligns more closely with studies emphasizing institutional conditionality rather than those suggesting an unconditional positive effect of FDI on tax revenue. While FDI can generate economic expansion, its ability to strengthen local fiscal capacity depends on whether local governments can effectively tax the resulting economic activities. From a theoretical perspective, this finding refines spillover theory by highlighting that spillovers alone are insufficient to improve subnational fiscal outcomes without complementary governance capacity. Policy-wise, it implies that FDI-attraction strategies should be accompanied by strengthened anti-corruption measures and improvements in local tax administration to ensure that foreign investment yields sustainable fiscal benefits at the regional level.

Government Expenditure on Local tax Ratio

The empirical findings consistently indicate that Government Expenditure (GEX) exerts a positive and statistically significant effect on the Local Tax Ratio, suggesting that public spending plays a crucial role in strengthening local fiscal performance. Government expenditure stimulates regional economic activity by increasing income, consumption, and productivity through investments in infrastructure, education, health, and social protection (Nan, 2021). These spending channels generate multiplier effects that expand the local tax base, particularly through higher household consumption, business turnover, and service utilization, thereby increasing locally collected tax revenues relative to GRDP.

This result supports the spend–tax hypothesis and the fiscal synchronization framework, which posit that public spending and revenue evolve jointly as governments expand expenditure to promote economic activity while subsequently enhancing tax collection to sustain fiscal balance (Maryantika & Wijaya, 2022). When public expenditure is allocated efficiently, it improves production capacity, reduces transaction costs, and enhances human capital, all of which contribute to a broader and more sustainable local tax base. Consequently, tax revenues grow not merely as a by-product of economic expansion, but as a reflection of improved fiscal capacity at the subnational level (Kirikkaleli & Ozbaser, 2023).

Importantly, this finding underscores that the fiscal effectiveness of government expenditure depends on its quality and composition. Productive and well-targeted spending strengthens regional economic fundamentals and enhances the ability of local governments to mobilize tax revenue. Therefore, effective budget planning, transparent execution, and outcome-oriented public financial management are essential to maximizing the fiscal returns of government expenditure and improving the Local Tax Ratio over time.

Inflation on Local Tax Ratio

The empirical results consistently show that inflation (INF) has a negative and statistically significant effect on the Local Tax Ratio (LTR) across all regression models. This finding indicates that rising price levels systematically weaken local fiscal performance. Inflation erodes household purchasing power, leading to a decline in real consumption, which directly reduces revenue from consumption-based local taxes such as hotel, restaurant, and entertainment taxes (Andini & Wijaya, 2024). Simultaneously, inflation increases production costs and compresses business profit margins, thereby lowering taxable income and weakening regional tax collection capacity.

From a fiscal perspective, inflation reduces tax revenue growth relative to GRDP, causing the Local Tax Ratio to decline even when nominal economic activity appears to expand (Silfiani, 2022). This outcome is consistent with the Olivera–Tanzi effect, which explains how inflation diminishes the real value of tax revenues due to collection lags and delayed adjustments in tax administration. As inflation accelerates, local governments face greater difficulty in maintaining the real value of tax receipts, particularly in regions with limited administrative flexibility.

Moreover, inflation introduces distortions in economic behavior and the tax system. Shrivastava (2021) notes that inflation can generate fiscal drag, where taxpayers experience higher nominal tax liabilities without corresponding real income gains, reducing disposable income and suppressing economic activity. These mechanisms collectively reinforce the negative relationship between inflation and the Local Tax Ratio, highlighting the importance of macroeconomic stability in sustaining subnational fiscal capacity.

Corruption as Moderator in the effect of FDI on local tax ratio

The empirical results indicate that corruption does not significantly moderate the relationship between Foreign Direct Investment (FDI) and the Local Tax Ratio (LTR). This finding suggests that variations in corruption levels do not systematically strengthen or weaken the effect of FDI on local fiscal performance. One key explanation lies in the institutional structure of fiscal decentralization in Indonesia, where a substantial portion of tax revenues associated with foreign investment—such as corporate income tax and value-added tax—is collected and administered by the central government rather than by local governments. As a result, changes in local corruption levels have limited influence on the extent to which FDI inflows translate into regional tax revenue,

making the local tax ratio relatively insensitive to governance conditions in this context (Eng & Lim, 2024).

Furthermore, multinational enterprises generally operate under standardized corporate governance, internal compliance, and tax planning frameworks that reduce their exposure to local bureaucratic inefficiencies and informal practices. These firms often rely on centralized licensing, fiscal incentives, and regulatory arrangements managed at the national level, thereby minimizing direct interactions with local government authorities (Wiguna & Wijaya, 2024). Consequently, the transmission mechanism through which corruption could potentially alter the fiscal impact of FDI at the subnational level becomes weak or fragmented.

Taken together, these findings imply that while corruption may influence broader economic efficiency and governance outcomes, it does not function as an effective moderating variable in the relationship between FDI and the Local Tax Ratio. The fiscal contribution of FDI to local governments appears to be driven more by structural features of tax assignment and intergovernmental fiscal arrangements than by local governance quality. This result highlights the importance of aligning theoretical expectations with the institutional realities of fiscal decentralization when examining the subnational revenue effects of foreign investment.

Corruption as Moderator in the impact of Government Expenditure on Local tax Ratio

The results demonstrate that corruption significantly weakens the positive effect of government expenditure on the Local Tax Ratio (LTR). In principle, increased government spending—particularly on infrastructure, public services, and economic development—should stimulate economic activity, raise productivity, and increase household income, thereby expanding the local tax base and enhancing regional tax revenue (Maryantika & Wijaya, 2022). Under such conditions, government expenditure is expected to generate a strong fiscal multiplier, translating public spending into sustained improvements in local fiscal capacity.

However, the presence of corruption fundamentally alters this transmission mechanism. The negative and statistically significant interaction term between government expenditure and corruption indicates that the marginal fiscal return of public spending declines as corruption intensifies. In more corrupt environments, a substantial portion of government expenditure is diverted through rent-seeking behavior, budget mark-ups, project leakage, and politically motivated misallocation of funds (Nguyen & Bui, 2022). These distortions reduce the quality, timeliness, and economic relevance of public projects, limiting their ability to stimulate productive economic activity and broaden the taxable base.

Empirically, this finding implies that an increase in government expenditure yields a smaller improvement in the local tax ratio in provinces with higher corruption levels compared to less corrupt regions. Public investments may result in cost overruns, incomplete or low-quality infrastructure, and poorly targeted social programs, all of which weaken the link between spending and economic output. Moreover, corruption erodes public trust and discourages tax compliance, further dampening the fiscal multiplier effect of government expenditure and reducing its effectiveness in generating sustainable local tax revenue.

Overall, these results highlight that government expenditure alone is insufficient to strengthen local fiscal capacity in the absence of good governance. Fiscal expansion that is not accompanied by improvements in transparency, accountability, and institutional quality is likely to produce diminishing returns in terms of local tax revenue mobilization. Therefore, enhancing governance quality is a necessary condition for ensuring that public spending translates into meaningful and sustainable gains in the local tax ratio.

Corruption as Moderator in the effect of Inflation on Local tax Ratio

The empirical results indicate that corruption does not moderate the relationship between inflation and the Local Tax Ratio (LTR). This finding suggests that the adverse effect of inflation on local fiscal performance operates independently of governance quality. Inflation directly reduces real purchasing power, suppresses household consumption, and weakens business profitability, thereby shrinking the tax base and lowering regional tax revenue, particularly from consumption-based local taxes such as hotel, restaurant, and entertainment taxes (Kurniasih et al., 2024). Because

these mechanisms arise from macroeconomic price dynamics, their impact on LTR tends to be automatic and largely uniform across regions.

Unlike government expenditure, whose fiscal effectiveness depends heavily on administrative discretion and institutional quality, the transmission of inflation to tax revenue does not rely on implementation capacity or governance decisions. Even in provinces with relatively low corruption, inflation-induced contractions in consumption and income still reduce taxable activities. Similarly, in highly corrupt regions, inflation may already have compressed economic activity and the tax base to a level where corruption cannot further intensify revenue losses (Margaryan & Terzyan, 2023).

This result also suggests the presence of a dominance effect, whereby macroeconomic shocks such as inflation outweigh institutional factors in shaping short-term local fiscal outcomes. As noted by Santos and Menezes (2024), inflation undermines fiscal performance primarily through real-sector and price-level channels, leaving limited scope for corruption to alter its transmission to tax revenue. Consequently, corruption fails to either amplify or mitigate the negative effect of inflation on the Local Tax Ratio, rendering its moderating role statistically insignificant.

CONCLUSION

This study concludes that government expenditure plays a significant role in improving local tax performance, as reflected by a higher local tax ratio, indicating a stronger effectiveness of locally assigned tax collection within Indonesia's decentralized fiscal framework. In contrast, the positive effect of Foreign Direct Investment (FDI) on the local tax ratio appears only in baseline estimations and loses statistical significance after institutional interactions are taken into account, suggesting that the fiscal benefits of FDI at the subnational level are not robust and may be constrained by the centralization of major tax instruments. Inflation is found to consistently exert a negative effect on the local tax ratio by eroding purchasing power, suppressing economic activity, and weakening the local tax base relative to regional output.

The moderation analysis further indicates that corruption significantly weakens the positive impact of government expenditure on local tax ratio, highlighting the role of governance quality in determining the effectiveness of public spending. Inefficiencies, misallocation of resources, and rent-seeking behavior reduce the capacity of government expenditure to translate economic activity into higher local tax revenues. By contrast, corruption does not significantly moderate the relationships between FDI and the local tax ratio or between inflation and the local tax ratio, suggesting that these relationships are primarily driven by structural features of tax assignment and macroeconomic dynamics rather than variations in governance quality. Overall, the findings underscore the importance of improving public financial management and governance to enhance the fiscal returns of government expenditure, while also recognizing the institutional constraints faced by local governments in leveraging investment and macroeconomic conditions to strengthen local tax performance.

To enhance the local tax ratio, policy efforts should focus on improving the effectiveness of government expenditure and strengthening institutional capacity at the subnational level. The findings suggest that the fiscal return of public spending is conditional on governance quality, highlighting the importance of transparency and accountability mechanisms in budget implementation. In this context, local governments are encouraged to strengthen monitoring systems, expand the use of digital-based fiscal administration, and adopt performance-oriented budgeting frameworks. While maintaining a conducive investment climate and macroeconomic stability remains important, their contributions to local tax performance appear to be indirect and context-dependent. Therefore, closer coordination between central and local governments in public financial management and tax administration is essential to improve subnational fiscal performance and support sustainable regional development.

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